In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 194

EQUITABLE PUBLISHING COMPANY, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

In the taxable years 1956 through 1960, petitioner Equitable Publishing Company failed to report as income more than $142,000, which it had obtained from the sale of advertising and diverted to North Penn Publishing Company, a corporation wholly owned by Equitable's controlling shareholders, petitioners Berky and Knipe. Petitioners claimed that the diverted funds were not actually earned by Equitable but were earned by North Penn for its contribution to a joint venture. The Tax Court found, however, that petitioners failed to establish either the existence of the claimed joint venture or the performance by North Penn of any substantial services for Equitable so as to render the diverted funds deducti-

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ble by the latter as a business expense (R. 362a–375a).[1] The court also found that the payments in question were taxable to Berky and Knipe as constructive dividends (R. 401a–407a, 410a–411a). Recognizing that the Tax Court's decision primarily turned on questions of fact and that the record amply supported the court's findings and conclusions, the court of appeals affirmed *per curiam* (Pet. App. A; 356 F. 2d 514). The decision below is correct and is not in conflict with the decision of any other court; there is no occasion for further review.

1. In 1952, Berky and Knipe each purchased half the stock of North Penn, which published a weekly advertising "throw-away" in the same area served by Equitable's daily newspaper. From 1952 to 1955 Equitable consistently made a profit, though it never paid a dividend (R. 338a, 354a), and North Penn consistently lost money, having a loss carryover in 1955 in excess of $31,000 (R. 346a). In 1955, the "advertising participation plan" which underlies this litigation was devised by petitioners' accountant and adopted by Equitable's shareholders (R. 346a–347a). In essence, the "plan" provided for annual distributions of a certain arbitrary percentage of Equitable's surplus earnings to North Penn.[2]

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[1] "R" refers to the petitioners' appendix filed in the court of appeals.

[2] Among the advantages of the complex formula, according to the minutes of Equitable's stockholders' meeting of January 17, 1955, were those "inuring to the Federal, State and Local Governments" (R. 346a). This is apparently a reference to the tax benefits expected to accrue from the diversion of Equitable's profits to the profitless North Penn.

Petitioners contend that the diverted funds, which exceeded the amounts reported by Equitable as net income in each of the years in question (R. 373a–374a), were earned by North Penn for promotional and protective services performed pursuant to an agreement with, and for the benefit of, Equitable. But the terms of the alleged agreement appear nowhere in the record. Although they suggested vaguely that North Penn promoted Equitable's advertising sales and deterred competitive weeklies from entering the market, petitioners have failed to show with particularity what services North Penn performed or how the alleged services had a value of $142,000. Indeed, the record shows that, during the years in question, Equitable's advertising income and lineage as well as its payments to North Penn steadily increased, while North Penn's advertising income and lineage and the size of its staff steadily declined (R. 355a). Since there was no change in the operations of North Penn after the adoption of the "plan" (R. 353a), it would appear on petitioners' theory that Equitable was paying increasingly more for increasingly less.

In fact, we submit, Equitable received nothing at all for the payments to North Penn. As the Tax Court correctly found, "the several advertising income participation agreements entered into by Equitable and North Penn * * * did not constitute real and genuine business transactions entered into by Equitable for profit or for any other proper business purpose but were for the mere purpose of distributing to North Penn earnings and profits of Equitable

without a business basis therefor" (R. 375a). In light of this holding, petitioners cannot properly contend, as they do (Pet. 12), that the existence of an actual joint venture was found by the Tax Court; nor can they properly rely on this Court's decision in *Commissioner* v. *Culbertson,* 337 U.S. 733. That opinion makes clear that the existence of a joint venture or partnership depends on the facts of each particular case and that the trial court is not required to find that a joint venture exists merely on the parties' assertion that a joint venture was intended.

2. It follows from the Tax Court's finding that the diversions from Equitable to North Penn were not for any substantial business purpose that the $142,000 of income unreported by Equitable is not deductible by it as an ordinary and necessary business expense. It is well settled that a corporate taxpayer cannot deduct payments made to cover expenses of its subsidiary or affiliate unless they are made to further the taxpayer's own business wholly apart from that of the recipient. *Interstate Transit Lines* v. *Commissioner,* 319 U.S. 590; *Dodd* v. *Commissioner,* 298 F. 2d 570 (C.A. 4); *Columbian Rope Co.* v. *Commissioner,* 42 T.C. 800, 815. Here the diverted funds not only covered North Penn's expenses but enabled it to make a small profit. These payments can in no way be considered as furthering Equitable's own business; on the contrary, they produced a marked reduction in Equitable's income (R. 373a).

During the relevant period, Equitable and North Penn were distinct corporate entities (R. 343a). They were related only in that Berky and Knipe,

sole owners of North Penn, were the controlling shareholders of Equitable.[3] That petitioners might have been able to achieve the tax benefits they claimed through a merger or other joinder of the two corporations (see Pet. 14–15), is without significance here. Having chosen to operate the two corporations separately, they may not claim the tax benefits of consolidation.

3. The courts below properly held that the funds diverted from Equitable to North Penn constituted constructive dividends to Berky and Knipe, who controlled the former and entirely owned the latter corporation. The amount of corporate funds taken by shareholders for their personal benefit, even if not paid directly into their hands, is taxable to the shareholders as a constructive dividend. See *Commissioner* v. *Makransky*, 321 F. 2d 598, 601–602 (C.A. 3); *Montgomery Engineering Co.* v. *United States*, 230 F. Supp. 838 (D. N.J.), affirmed *per curiam*, 344 F. 2d 996 (C.A. 3). That the disbursing corporation may have other shareholders who do not receive payments or benefits on a *pro rata* basis is immaterial. See, *e.g.*, *Oyster Shell Products Corp.* v. *Commissioner*, 313 F. 2d 449, 452, n. 4 (C.A. 2); *Lengsfield* v. *Commissioner*, 241 F. 2d 508, 511 (C.A. 5).

Equitable failed to prove that it purchased goods or services from North Penn, and if did not claim that the payments in question were made as a gift or loan. The only other means by which the diverted

[3] Berky and Knipe's ownership of Equitable's 740 non-Treasury shares increased during the period in question from 313 shares each to 369 shares each (R. 337a–338a).

funds could properly have been transferred from Equitable was through dividends to Berky and Knipe, who in turn would pay the money over to North Penn. Although no formal dividends were declared, Berky and Knipe, through their control of Equitable, were able to direct the disposition of that corporation's surplus as they saw fit.[4] As the Tax Court found, they used this power to cause Equitable to make the payments in question to North Penn (R. 402a). There is no merit in petitioners' argument (Pet. 20) that Berky and Knipe received no benefit from these payments to North Penn, their wholly-owned corporation. *Cf. Montgomery Engineering Co.* v. *United States, supra* (payment to widow of former corporate executive directed by controlling shareholder). Berky and Knipe's exercise of their power to control the disposition of Equitable's income in the manner revealed by the present record was properly held to result in income taxable to each of them during the years in question. See *Helvering* v. *Horst,* 311 U.S. 112.

[4] The bank which was trustee for most of Equitable's other shareholders was trying to sell the shares held by it during the period in question (R. 205a–206a). The record fails to support petitioner's contention (Pet. 17–18) that the role played by the trustee in Equitable's affairs was such as to negate the possibility that Berky and Knipe were able to divert Equitable's funds for their own purposes.

For the foregoing reasons, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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